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Financing Small Business Is Critical for a Strong Post-Covid Recovery

By Agnes Dasewicz, John Simon, and Sundar R. Ramanujam

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THE ISSUE

- Small businesses constitute more than 90 percent of the global private sector, providing 70 percent of all the jobs, and drive half the global economy. With the sector already facing a significant financing gap even before the outbreak of the deadly Covid-19 virus, the pandemic has only made the financial vulnerabilities an existential threat for many firms.
- This brief explores how the next presidential administration can consider short-term and medium-term tools to help mobilize private capital, revive the global economy, address the risks to small business financing, and ensure an inclusive domestic economic recovery.

INTRODUCTION

Businesses that employ fewer than 250 persons are categorized under micro, small, and medium enterprises (MSMEs). They make up more than 90 percent of all firms worldwide, provide 70 percent of all employment, and constitute roughly half of the global economy. In the next ten years, more than 600 million new jobs will be needed globally to meet the needs of a growing workforce, much of them in emerging markets.[1] Therefore, policymakers must prioritize the development of a resilient MSME sector. Recognizing the importance of this issue, CSIS partnered with the Tipping Point Fund on Impact Investing to convene two working groups examining the state of play of the MSME sector in Africa and the United States. This brief builds on the working groups' findings, with a particular focus on the consequences of Covid-19 on the sector. This brief also looks at the available opportunities for collaboration that impact investors, policymakers, and other philanthropic institutions could use to build resilience in the MSME sector, as the world plans a post-pandemic economic recovery and strives to meet its broader sustainable development goals.

AFRICA: A LARGE FINANCING GAP FOR SMALL BUSINESSES

MSMEs constitute nearly 90 percent of all businesses operating in Africa, and they are responsible for 80 percent of the continent's employment.[2] However, MSMEs face several obstacles if they are to generate the scale needed to absorb the large upcoming number of entrants to the labor force. While Africa's working-age population is expected to grow by 450 million over the next 15 years, jobs (both in the formal and informal sectors) are expected to increase by only 100 million.[3] Additionally, businesses across Africa face several constraints, including poor infrastructure networks: with two-thirds of the continent lacking access to national road networks and nearly 600 million people without electricity, Africa is one of the least connected regions in the world.[4] A 2019 survey of 97 technology firms in Nigeria found that nearly one out of three

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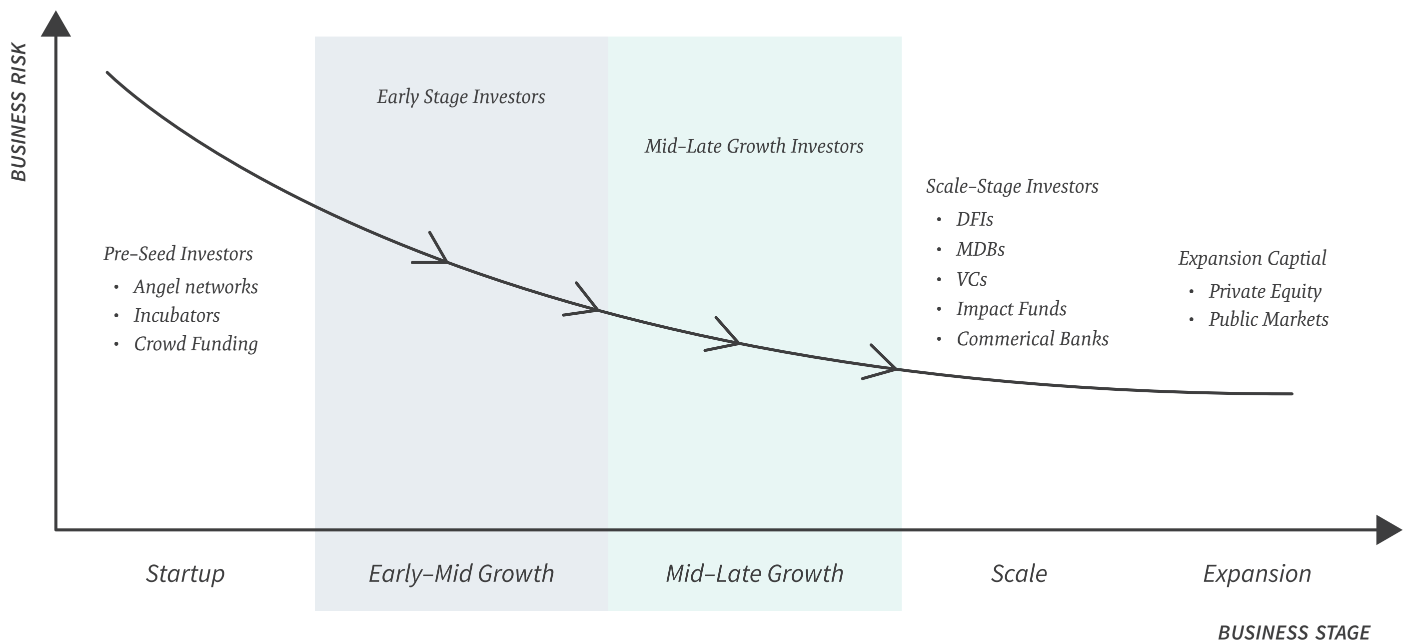
firms lost up to 20 percent of their business sales due to frequent power outages. The same survey found that over 77 percent of firms experienced at least 20 outages each month, each outage lasting at least a few hours.[5] While connectivity challenges severely impact MSMEs' ability to fully participate in global value chains, firms most often cite the growing financing gap as their most significant obstacle.[6] The financing gap for MSMEs in the developing world stands at US$ 4.8 trillion, with a substantial part of this gap constraining firms at the mid-late growth stage of innovation (Figure 1).[7]

According to the International Finance Corporation (IFC), in 2019 the MSME financing gap represented 17 percent of the national GDP for the average African country, with that number doubling to 33 percent for some of the more populous countries, like Nigeria and Kenya.[8] A CSIS analysis attributed the multitrillion-dollar MSME financing gap in the developing world to a "missing middle" between the early and late growth stages of the business cycle (see Figure 1).[9] With the *Startup*, *Scale*, and *Expansion* stages already having a well-established network of investors and financiers who can tolerate the risks in those stages, it is MSMEs in the *Early-Mid Growth* and *Mid-Late Growth* stages that are unable to secure enough capital from investors . A way to overcome this financing gap could be to rely on an intermediary financial vehicle to provide investment capital to developing world MSMEs in the middle of their growth stage.

The challenges to sustainable financing for MSMEs have become even more pronounced with the onset of the Covid-19 pandemic, as government authorities are severely constraining their operations. A survey of Ugandan firms in April 2020 reported that 58 percent of micro-enterprises would have to close if pandemic-driven restrictions were maintained for three months; among small firms, a majority said they would have to close if the status quo remained unchanged for up to six months.[10] If current trends continue, the worst may be yet to come, and the hardest-hit victims will be those employed by MSMEs.[11]

Figure 1: Stages of Growth



Source: Neil C. Churchill and Virginia L. Lewis, "The Five Stages of Small Business Growth," Harvard Business Review, May 1983.

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Since 60 percent of African households report informal sector earnings as their primary source of income, the average worker is less likely to have a social safety net to rely on if they lose their job.[12] Moreover, in the most impoverished settings, workers face the harrowing dilemma of having to either miss work and risk food insecurity or go to work and risk catching the virus.[13]

Relatedly, the pandemic has also worsened one of the more ubiquitous challenges of financing MSMEs in Africa: the high information costs for formal sector lending. Commercial financial institutions have a fiduciary responsibility to protect themselves from high-risk exposure. They do this by undertaking due diligence and making risk assessments on potential borrowers. However, the costs of undertaking credible risk assessment have increased significantly with Covid-19; consequently, local commercial lenders have pulled back on their financing in general, given the higher-risk environment.[14]

In the African context, transaction sizes are often small, owing to the nature of the market and the scale of the economies—some firms need as little as $20 to $300 in loans, amounts more appropriate for microlenders.[15] Conversely, compared to the average size of loans, information costs are relatively high in the region, as credit rating agencies are an underdeveloped institution.[16] This has resulted in an unintended consequence whereby financial institutions limit themselves to a minority of MSMEs: repeat customers, whose past performance record with the banks makes it easier to establish their creditworthiness.[17]

A closer look at the economic landscape finds that two main factors are responsible for raising transaction costs high, thus making credit access for MSMEs with small transactions an unprofitable venture. First, MSMEs in Africa operate in an economy where the **regulatory constraints** faced by businesses are the highest in the world. Regulatory restrictions have first-order implications on a number of business functions, including contract design and enforcement, barriers to entry (difficulty in procuring operating licenses, construction permits, and electricity connections) and exit (resolving bankruptcy and insolvency issues, asset sales, hiring and firing constraints), and a punitive tax code. The World Bank's Doing Business Index, which evaluates regulatory restrictions on businesses in countries around the world, found that 12 of the 20 worst-ranked countries were in sub-Saharan Africa.[18] While Togo and Nigeria undertook promising market reforms in 2018–2019, most other countries in the region have much left to do if they want to make their economies more hospitable to MSME growth and development.[19]

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The cumbersomeness of the regulatory regime often pushes firms into **informality**, a second factor contributing to high transaction costs. Between 2010 and 2014, the informal sector accounted for about 38 percent of the region's GDP; 86 percent of all MSME employment was also determined to take place in the informal sector.[20] Between the excessive regulatory constraints and the informal economy that has emerged under it, most MSMEs end up with improper regulatory clearances or permits and poor recordkeeping, which subsequently makes it difficult for them to produce the information necessary for formal-sector lending. Their inability to furnish such information leads to high transaction costs for most firms. Unsurprisingly, less than 17 percent of firms in developing countries in Africa use formal loans (in other developing regions, nearly twice as many enterprises used loans).[21] This pushes MSMEs to rely on informal networks for credit and financing, which typically involve close friends and relatives—with limited pools of capital—or predatory informal lenders.[22]

UNITED STATES: THE UNDERLYING FAULT LINES FOR SMALL BUSINESSES BECOME EXPOSED

Much like Africa, small businesses in the United States are a vibrant part of the economy. In 2019, MSMEs in the United States were responsible for employing more than 47 percent of workers in the private sector, and (despite being struck hard by the 2008 financial crisis) created about two-thirds of all jobs between 2000 and 2018.[23] However, the U.S. spread of the deadly coronavirus (that has already claimed over 185,000 lives and affected millions of others) has triggered an economic recession which has consumed more than 18 million jobs—two-thirds of which are in the MSME sector.

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The economic crisis that grips the United States can be traced to a series of fault lines, detailed below, that have become exposed due to the effects of a broader public health crisis that shows no signs of stopping.

UNDERCAPITALIZED SECTOR

The depth and development of the U.S. financial sector are unrivaled in the global economy.[24] However, its finance is not equally accessible to everyone, as is notably the case for MSMEs. Even until 2019, MSMEs had been overwhelmingly undercapitalized, with more than four out of five MSMEs never having accessed bank loans or venture capital.[25] As a result, in 2019, only 20 percent of all healthy firms reported that they would be able to continue normal operations if they experienced a two-month revenue loss.[26] The pandemic has therefore not only introduced new obstacles but amplified existing challenges for the MSME sector. The non-institutional mechanisms that MSMEs use for sourcing capital (such as community development finance institutions and fintech) have made it quite difficult for even the U.S. federal government to deliver resources to small businesses in the wake of the Covid-19 pandemic. During the Paycheck Protection Program loan, for instance, millions of the nation's MSMEs could not readily access capital they needed. A McKinsey report estimates that without intervention, 25 to 36 percent of MSMEs had to close permanently in the first four months of the pandemic.[27]

THE CLUSTER PROBLEM

Another obstacle facing MSMEs in the United States is that venture capital investors, responsible for the significant growth of many private sector enterprises, limit themselves geographically and only invest in MSMEs operating in a handful of markets. A quick survey finds that over 75 percent of the total dollar value of venture capital deals in 2017 was concentrated in California, New York, and Massachusetts, leaving the rest of the country behind.[28]

ECONOMIC AND SOCIAL INEQUITIES

Even pre-crisis, in 2018, only 2 percent of venture capital went to women and 1 percent to people of color.[29] Bank lending was also not widely available. Historical discrimination plays a vital role: fearing rejection at the outset, Black business owners often do not apply for loans even when they need them.[30] Instead of turning to formal banks, Black businesses are more likely to draw on owner equity and informal borrowing from family members.[31] The funding that they can accumulate from these sources is smaller than what is available through formal credit channels, so Black-owned businesses start with lower levels of financial capital.[32] Similar patterns exist for firms owned by Latino and Native American entrepreneurs, as well as by women.[33] As a result of these factors, the situation for MSMEs in the United States, especially those led by minorities and women, is tenuous. Many minority or female business owners are concerned about their ability to stay in business amid the Covid-19 pandemic: 58 percent of minority small business owners are "extremely" or "very" concerned about their firm's financial viability, compared to 47 percent of all small business owners.[34] The Financial Times calls small businesses the "canary in the U.S. economic coal mine," arguing that their layoffs and insolvencies are a better gauge of the country's economic health than the state of the markets; the status of minority-owned small businesses could be an even earlier warning sign.[35]

Despite these obstacles, new channels of capital to deliver financing to small businesses in the United States have emerged in recent years. Online lenders are becoming one of the preferred source of credit for MSMEs.[36] While some online lenders engage in predatory practices, those that have committed to transparency in lending are supporting millions of small businesses. At the same time, community development finance institutions and community-based lenders, who may have been traditionally focused on affordable housing, have become much more active in investing in local businesses. These investors can assess investment risk without basing themselves on credit scores or on the value of the collateral; instead, they use artificial intelligence, algorithm-based financial technologies, and local community knowledge to allocate capital to their client businesses. Finally, new funds are looking to fill the need for innovative capital for small businesses outside of the major financial centers. Capacity Capital, for example, serves businesses in the Southeast from their base in Chattanooga, Tennessee, and Collab Capital focuses on founders of color and is based in Atlanta.[37] These new funds offer innovative financing products, such as revenue-based finance rather than straight debt or equity, to invest in entrepreneurs left behind by venture capitalists.

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THE PATH AHEAD

The obstacles confronting both the African and U.S. MSME sectors have been exacerbated by the global pandemic. While there are nuanced cultural and political differences between the two regions, the actions necessary to address the obstacles they face are similar.

In the case of Africa's MSME sector, the difficulty of accessing domestic financial capital is not entirely an outcome of misaligned institutions—rather, it results from the lack of proper institutions and from undeveloped capital markets. Consequently, MSMEs find themselves drawn towards financial vehicles and platforms supported by international development agencies. The International Finance Corporation, a unit of the World Bank, is a major source of venture capital for MSMEs in the developing world; the African Development Bank, the U.S. International Development Finance Corporation, and the European Investment Bank offer additional sources of funding for enterprises in Africa. Governments, international financial institutions, firms, and foundations have the potential to empower the MSME sector through targeted and catalytic investments in the form of grants, loans, equity investments, and guarantees to unlock domestic and foreign private capital—the combination of which is called "blended capital." However, these efforts are not entirely sufficient, as MSMEs are still struggling to find appropriate risk capital to weather the ongoing crisis. Thus, stakeholders need to consider new financing strategies that recognize the challenges for MSMEs, and the unexpected realities posed by Covid-19, in order to ultimately help them mobilize the hundreds of billions of dollars in private capital needed.

In the United States, policymakers and other stakeholders are all actively working towards rebuilding a more resilient U.S. economy. Since small businesses create the vast majority of U.S. jobs, recovery plans must focus on how to support rebuilding these firms. The U.S. government should support intermediaries who deliver appropriate capital to small businesses—CDFIs, transparent fintech firms, and local funds—and link them to investors who are looking to deploy capital outside of the financial hubs. Particular focus needs to be placed on minority- and women-owned businesses, since they have driven economic growth over the last few decades and have historically been underserved by traditional finance.

Given the above context, the following six actions can be considered by stakeholders of the global MSME sector:

SHORT-TERM ACTIONS

- **Deploy Non-traditional Financing Tools to Help Businesses Weather the Downturn**
  In extraordinary times such as the ongoing pandemic, restructuring debt and mitigating short-term risks are key to avoiding long-term crises. To that end, impact investors and development partners should strongly consider using alternatives to traditional lending and financing tools, which involve amortization of loans and fixed-rate payments. Instead, they can increase their support for non-traditional financing products such as:

  revenue-based financing: an investment product where the investor receives a fixed percentage of the business' gross revenue until a multiple of the original investment is paid. Also known as *royalty-based financing*.

  invoice factoring: a financing tool that allows firms to leverage the value of their invoices or sales summary for an immediate release of funds from a lender or bank equivalent to a partial value of the sales, with the funder releasing the remainder value (minus fees) upon collection of the payment. Useful when cash reserves dry up due to a lockdown-driven demand shock. Relatedly, firms can also consider *invoice discounting* to deal with short-term cashflow issues.

  crowdfunding: a financing mechanism whereby the firm relies on a large pool of individual contributors for funding instead of a smaller pool of traditional high-value investors such as banks. Each contribution, usually of small value, is made in the form of a donation (or a grant), with no repayment obligation for the recipient.

  guarantee: a legally binding agreement that allows the guarantor to assume the partial (or total) risk for a

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firm in its payment obligation to a lender or investor in the event of non-payment. This tool can be used not only to catalyze private capital in underserved industries and minority-owned businesses but also to help enhance the creditworthiness of MSMEs that have had a good performance record but are facing existential threats due to medium-term revenue shortfalls.

Social (or development) impact bonds: a relatively new and innovative mechanism, it is a form of public-private partnership that ensures efficiency in development finance and increases the role for private sector in social development. Governments can use social impact bonds to get the private sector to invest in expanding minority-owned MSMEs' access to finance. The specific targets and outcomes are predetermined in an objective and independent manner and only when they are met does the government pay the investors back the principal and a profit.

- **Partner with Local Stakeholders to Make Targeted Investments**
  Local networks are critical when assessing the risk or impact of any investment in the informal economy, as they have access to reliable and verifiable information with a high level of granularity. As mentioned above, there is a lack of identity documents and records in much of Africa, with many people living in sparsely populated rural communities and having low rates of literacy.[38] In such contexts, locally produced and culturally responsive knowledge becomes critical for making assessments on financing and lending. Thus, impact investors and development finance partners seeking to expand their investment portfolio should partner with local communities. These partnerships can, in turn, be leveraged to identify a pipeline of projects (entrepreneurs) and investors (such as community banks, microcredit institutions, and community development finance institutions) and provide them with the access investment guidance and technical expertise necessary to mitigate risk factors and to improve the overall investment grade of the projects.

MEDIUM-TERM ACTIONS

- **Use Risk Capital to Support Pooled Vehicles**
  Impact investors and official development agencies can support pooled vehicles to usher in greater private investments. Blended capital tools can also be used to aggregate opportunities, mitigate risks, and attract more traditional investors to underserved industries and entrepreneurs within the broader global MSME sector. More significantly, such blended capital mechanisms can also develop and support investment vehicles (such as the Global Innovation Fund) in creating a financing pipeline for MSMEs which are constrained in the growth stage.
- **Help MSMEs Diversify Their Supply Chains Geographically**
  Although globalization has made global supply chains well-integrated and has brought down overall economic costs of production, it is overly dependent on a handful of economies (including China). Consequently, an estimated 55 percent of the global MSME sector experienced sourcing challenges in the early days of the pandemic. With MSMEs often lacking the cash-on-hand to absorb the costs of diversifying their supply chains, development finance institutions and multilateral development banks have a critical role to play.[39] Impact investors—and to a greater extent, bilateral and multilateral institutions—should support efforts to de-risk global supply chains. In particular, they should ease the transition costs imposed upon MSMEs (both in Africa and the United States) attempting to diversify their sourcing, production, and management systems development, encouraging the growth of local supply chains.

  Congress, in particular, should take priority interest in helping U.S. firms in sectors of strategic importance. These interventions can be made by authorizing the departments of Commerce and Treasury, along with the Small Business Administration, to use **grants** and **concessional loans** to alleviate the transition costs associated with diversification. At the same time, Congress can also set up **enterprise funds** to develop the private sector and market institutions in low- and lower-middle-income countries, thereby expanding the list of feasible country alternatives for firms to work with as they consider their diversification options. Similarly, the United States can also coordinate with other donor countries (such as Britain, Canada, France, and Japan) in using their development finance toolkits to support African businesses' diversification efforts.
- **Assist in the Development of Local Financial Institutions and Capital Markets**
  No amount of aid intervention or financial support can address fundamental challenges with governance and market institutions. In Africa, development partners should prioritize formalizing the economy, deregulating markets, strengthening institutions and the rule of law, and enabling access to domestic capital

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markets (for increased formal lending) in their efforts to undertake market reforms. The ultimate goal is to lower information costs and increase the formalization of the economy, such that the MSME sector becomes self-sustainable and resilient in the post-pandemic world. In many low- and lower-middle-income African countries, this can be achieved by using guarantees and combining them with policy reforms. Donor aid agencies and development finance institutions can coordinate in this area, with the latter offering the guarantees that are conditional upon the recipient undertaking technical assistance from the former.[40] Additionally, multilateral development banks can also use policy-based guarantees to help countries with structural reforms. In the United States, there is a need to rebuild the financial architecture of how small businesses—especially those headed by women and minorities—access finance. Congress should review the over 80 small business support programs which span several agencies and are often deployed in a fragmented fashion. Such a review would identify which changes can be made to support the ways small businesses access finance today, and it could determine where efficiencies and improvements could be made. Congress can also consider establishing a new agency that has the mandate to expand access to finance for the MSME sector, effectively driving sustainable economic growth in the post-pandemic economy.

CONCLUSION

Regardless of the winner of the 2020 U.S. presidential elections, the next administration will confront the dual challenge of reviving a struggling global economy while ensuring an inclusive domestic economic recovery. In anticipation, this brief has presented action-oriented ideas that have either been used by recent administrations (of both political parties) or had overwhelming support from development practitioners and financial experts in the field. Both political parties have also made it their top priority to lead the United States and the world into a post-pandemic phase. And so, as policymakers return to Washington with a fresh mandate in 2021, it is critical that they work towards a rapid and sustained global economic recovery by ensuring that the inequities and vulnerabilities of the past do not find their way into the future.

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